

Office of Chief Counsel
Internal Revenue Service

memorandum

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RWDillard

date: April 17, 2002

to: Internal Revenue Service, Examination Division
Attn: RA Peggy Bockman

from: Associate Area Counsel
(Retailers, Food, Pharmaceuticals & Health Care)

subject: [REDACTED]

Advisory Opinion

Issue

Whether "insurance premiums" paid to a related, offshore insurance company should be disallowed and, if so, what theories can the Internal Revenue Service assert in a notice of deficiency to disallow the deductions.

Conclusion and Summary

It appears that a portion of the amounts paid should be disallowed because the premiums paid by [REDACTED] were in excess of arm's length commercial rates. [REDACTED], (b)(5)(AC)

In implementing I.R.C. §§ 482 and 845(a), the standard to apply is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer. [REDACTED], (b)(5)(AC)

[REDACTED]
[REDACTED], (b)(5)(AC)

[REDACTED]
[REDACTED], (b)(5)(AC), [REDACTED]

(b)(5)(AC)
 , (b)(5)(AC)

Facts

We understand the facts are as follows. The Internal Revenue Service is examining [REDACTED] (" [REDACTED] ") for the fiscal years ending 3/31/[REDACTED], 3/31/[REDACTED] and 3/31/[REDACTED]. [REDACTED] is a C corporation engaged in [REDACTED] construction. There are a number of entities within the consolidated group, and a number of related entities outside of the consolidated group.

The following individuals and entities owned stock in [REDACTED] as of March 31, [REDACTED]:

<u>Shareholder</u>	<u>Shares Owned</u>	<u>% Owned</u>
[REDACTED]	[REDACTED]	[REDACTED]%
[REDACTED]	[REDACTED]	[REDACTED]%
[REDACTED]	[REDACTED]	[REDACTED]%
[REDACTED]	[REDACTED]	[REDACTED]%
[REDACTED]	[REDACTED]	[REDACTED]%
[REDACTED]	[REDACTED]	[REDACTED]%
[REDACTED]	[REDACTED]	[REDACTED]%
[REDACTED]	[REDACTED]	[REDACTED]%
[REDACTED]	[REDACTED]	[REDACTED]%
Total	[REDACTED]	[REDACTED]%

[REDACTED] (" [REDACTED] ") is the sole owner of [REDACTED] and [REDACTED], are [REDACTED]'s three children. [REDACTED] is [REDACTED]'s sister.

[REDACTED]'s three children are equal shareholders in [REDACTED], LLC. [REDACTED], LLC wholly owns [REDACTED] (" [REDACTED] "). [REDACTED] was incorporated on 3/31/[REDACTED] in the [REDACTED]. [REDACTED] elected to be treated as a

domestic corporation under I.R.C. § 953(d). [REDACTED] also elected to be taxed on only its investment income under I.R.C. § 831(b)¹.

[REDACTED] has a self-insured workers' compensation program. [REDACTED] (" [REDACTED] ") manages the program. In [REDACTED], [REDACTED] started entering into reimbursement agreements with [REDACTED]. Pursuant to the agreement, [REDACTED] agreed to reimburse [REDACTED] for claims made against its self-insured workers' compensation program. According to the agreement, [REDACTED]'s loss limits are \$ [REDACTED] per each occurrence and \$ [REDACTED] annually. [REDACTED] issued the following "policies" to [REDACTED]:

Policy No. [REDACTED]	covers the period 4/1/ [REDACTED] through 3/31/ [REDACTED]
Policy No. [REDACTED]	covers the period 4/1/ [REDACTED] through 3/31/ [REDACTED]
Policy No. [REDACTED]	covers the period 4/1/ [REDACTED] through 3/31/ [REDACTED]
Policy No. [REDACTED]	covers the period 4/1/ [REDACTED] through 3/31/ [REDACTED]
Policy No. [REDACTED]	covers the period 4/1/ [REDACTED] through 3/31/ [REDACTED]

[REDACTED] paid [REDACTED] \$ [REDACTED] for each policy since policy [REDACTED]. [REDACTED] made the payment on March 31st of each policy period. The taxpayer's representatives have explained that [REDACTED] was responsible for all claims that came in prior to March 31st for each policy period. For example, on March 31, [REDACTED], [REDACTED] paid \$ [REDACTED] for policy [REDACTED], which covered 4/1/ [REDACTED] through 3/31/ [REDACTED]. If a claim came in on [REDACTED] (for an injury that occurred during 4/1/ [REDACTED] through 3/31/ [REDACTED]), [REDACTED] paid the claim and was not entitled to reimbursement. If the claim came in on [REDACTED] (for an injury that occurred during 4/1/ [REDACTED] through 3/31/ [REDACTED]), [REDACTED] paid the claim and was reimbursed by [REDACTED]. For each year at issue, [REDACTED] deducted any claims which it paid during the year and deducted the \$ [REDACTED] that it paid to [REDACTED].

[REDACTED] has no employees and has its bank account in [REDACTED]. [REDACTED] conducts no other business. [REDACTED] is not aware of [REDACTED]'s agreement with [REDACTED].

DISCUSSION

¹ By making this election, [REDACTED] can exclude from income up to \$ [REDACTED] of insurance premiums annually.

1. Section 482

The Internal Revenue Service has broad discretionary power to allocate income under I.R.C. § 482, and the taxpayer has a heavier than normal burden to prove that the allocation is arbitrary or unreasonable. Procter & Gamble Co. v. Commissioner, 95 T.C. 323, 331 (1990), aff'd, 961 F.2d 1255 (6th Cir. 1992). I.R.C. § 482 provides, in pertinent part:

In any case of two or more organizations, trades, or businesses . . . owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions . . . between or among such organizations . . . if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations

Thus, for I.R.C. § 482 to apply, a transaction must be between two or more entities owned or controlled by the same interests, and the allocation must be necessary in order to prevent evasion of taxes or clearly reflect income.

The regulations broadly define control "to include any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised." Treas. Reg. § 1.482-1(a)(3). In this case, the corporations were clearly owned and controlled by the same interests.

It appears that disallowing a portion of the \$ [REDACTED] "premium" paid by [REDACTED] is necessary to prevent evasion of taxes and/or clearly reflect income. It is probably no coincidence that [REDACTED] paid \$ [REDACTED] to [REDACTED] each year and that the premium never changed. This is the amount equal to the exclusion for small insurance companies under I.R.C. § 831(b). Additionally, [REDACTED]'s payment of \$ [REDACTED] annually for insurance up to \$ [REDACTED] seems extremely excessive. Obviously the \$ [REDACTED] exclusion under I.R.C. § 831(b) provided an opportunity for [REDACTED] to turn its taxable income into nontaxable income by paying an excessive "premium."

When making an allocation under I.R.C. § 482, the standard to be applied is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer. Treas. Reg. § 1.482-1(b)(1). (b)(5)(AC) [REDACTED]

(b)(5)(AC)

2. Section 845

In addition to I.R.C. § 482, the Internal Revenue Code contains an additional reallocation provision that applies specifically to insurance companies. Section 845(a) generally allows the Internal Revenue Service to reallocate income between two or more related parties who are parties to a reinsurance agreement. (b)(5)(AC)

3. Section 162

Generally, premiums paid for insurance are deductible under I.R.C. § 162(a) if directly connected with the taxpayer's trade or business. Treas. Reg. § 1.162-1(a). However amounts set aside as reserves for the payment of anticipated losses are not deductible business expenses under I.R.C. § 162(a). United States v. General Dynamics Corp., 481 U.S. 239, 243-244 (1987); Stearns-Roger Corp. v. United States, 774 F.2d 414 (10th Cir. 1985); Spring Canyon Coal Co. v. Commissioner, 43 F.2d 78 (10th Cir. 1930).

Although the Internal Revenue Code does not define "insurance," to constitute insurance a transaction must involve "risk shifting" (from the insured to the insurer) and "risk distribution" (by the insurer). Helferich v. Le Gierse, 312 U.S. 531, 539 (1941). Risk shifting has been described as involving "the shifting of an identifiable risk of the insured to the insurer." Humana, Inc. v. Commissioner, 881 F.2d 247, 251 (6th Cir. 1989). Risk distribution involves shifting to a group of individuals the identified risk of the insured. Id. The focus

² The agreement between [REDACTED] and [REDACTED] provides that policy premiums and loss limits will be determined by an independent actuary.

is broader and looks more to the insurer as to whether the risk insured against can be distributed over a larger group rather than the relationship between the insurer and any single insured. Id.

Each court that has addressed whether a parent corporation can deduct as insurance premiums payments made to its captive insurance subsidiary has concluded that the underlying transaction does not involve sufficient risk shifting to constitute insurance where the captive insures only its parent or parent's other subsidiaries. E.g., Carnation Co. v. Commissioner, 640 F.2d 1010 (9th Cir. 1981); Clougherty Packing Co. v. Commissioner, 811 F.2d 1297 (9th Cir. 1995). The Sixth Circuit and Court of Claims, however, have held that payments to a captive insurer by its sibling subsidiary were deductible as insurance premiums. Humana, Inc. v. Commissioner, 881 F.2d 247 (6th Cir. 1989); Kidde Industries, Inc. v. United States, 40 Fed. Cl. 42 (1997).

Where the captive insurer accepts risks of unrelated entities, including brother-sister corporations, some courts have held that risk shifting and risk distribution are present and allowed a deduction for premiums paid. Harper Group v. Commissioner, 979 F.2d 1341 (9th Cir. 1992) (holding that risk shifting and risk distribution are present where the captive received 29 to 32 percent of premiums from unrelated parties). Where the percentage of insurance for unrelated entities is de minimus, however, courts have found no risk shifting or risk distribution. See, e.g., Gulf Oil Corp. v. Commissioner, 89 T.C. 1010 (1987) (explaining that risk distribution not present where captive received 2 percent of risks from unrelated parties), aff'd. on this issue, rev'd. on other issues, 914 F.2d 396 (3rd Cir. 1990).

In this case, [REDACTED] did not receive premiums from any unrelated parties. This fact favors finding that no risk shifting or risk distribution occurred. See Gulf Oil Corp., supra. However, it is not clear whether a court would find that the transaction in this case lacked risk shifting and/or risk distribution because [REDACTED] was not owned by [REDACTED], as in the cases cited above.

In Crawford Fitting Co. v. United States, 606 F. Supp. 136 (N.D. Ohio 1985), an Ohio District Court found that a transaction exhibited risk shifting and risk distribution where the insurance company's owners were not within the corporate family. In Crawford, the insured corporate taxpayer was not the parent of the insurance company or a sibling subsidiary of the insurance company. Instead, the insurance company was owned by individuals

who were also the owners or officers of the insured company, or relatives of those persons.

The Crawford Fitting Court noted that the different ownership relations were crucial to whether the taxpayer had obtained insurance. The court found "that the taxpayer and the other shareholders of the captive insurance company, as well as the insureds, were not so economically related that their separate financial transactions must be aggregated and treated as a single taxpayer."

Like Crawford Fitting, [REDACTED] is not the parent of [REDACTED], so a court could find that risk shifting and risk distribution are present³. [REDACTED]

[REDACTED]

4. Sham

The United States Supreme Court has stated the general rule that, absent an exception, e.g., where the arrangement is a sham or a tax fraud, a corporation should be viewed as a separate taxable entity. Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943). If the arrangement is a sham, however, payments to a captive insurer are treated as nondeductible reserves and not insurance premiums. Malone & Hyde, Inc. v. Commissioner, 62 F.3d 835, 839 (6th Cir. 1995).

The question of whether a transaction is a sham is highly factual. Factors to consider in determining whether a captive is a sham include:

1. Whether premiums charged by the captive were based on arm's length commercial rates.
2. Whether the captive insurer paid claims from its own funds, which were separately maintained from the insured.
3. Whether the captive had adequate capitalization.

³ [REDACTED] and [REDACTED] do not qualify as a brother-sister controlled group under I.R.C. § 1563(a)(2). The attribution rules under I.R.C. § 1563(e)(6) do not apply in this case. Finally, the attribution rules under I.R.C. §§ 267 and 318 do not apply to I.R.C. § 1563.

4. Whether the captive's business operations and assets were kept separate from the insured.

5. Whether evidence of a valid business purpose for the formation of the captive exists.

6. Whether the captive was loosely regulated by the locale in which the captive was incorporated.

Malone & Hyde v. Commissioner, 52 F.3d 835 (6th Cir. 1995); Ocean Drilling & Exploration Co. v. United States, 24 Cl. Ct. 714, 728-729 (1991), aff'd 988 F.2d 1135 (Fed. Cir. 1993).

At this time, the case is not adequately developed for us to determine whether [REDACTED] was a sham. [REDACTED], (b)(5)(AC),

, (b)(5)(AWP)

, (b)(5)(AWP)

If you have any questions, please contact the undersigned at (904) 665-1987.

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